

Hastings International and Comparative Law Review

Volume 6
Number 3 *Spring* 1983

Article 2

1-1-1983

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Recommended Citation

Joel Rabinovitz, *Foreign Investment in United States Real Estate*, 6 HASTINGS INT'L & COMP.L. Rev. 599 (1983).
Available at: https://repository.uchastings.edu/hastings_international_comparative_law_review/vol6/iss3/2

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Foreign Investment in United States Real Estate

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I. OPERATING INCOME

The taxation of a nonresident alien or a foreign corporation on rents from real property located in the United States will depend on whether the foreign individual or corporation is engaged in a trade or business in the United States. Internal Revenue Code [I.R.C.] §§ 871, 881.

A. A foreign person engaged in a trade or business in the United States will be taxed on rental income on a net basis after allowance of all deductions, including Accelerated Cost Recovery System (ACRS) depreciation. I.R.C. §§ 871(c)(1)(A), 168.

1. Whether a foreign person is engaged in trade or business¹ in the United States is a factual question.

a. Activity "in connection with domestic real estate that is beyond the mere receipt of income from rented property, and the payment of expenses incidental to the collection thereof, places the owner in a trade or business within the United States, provided such activity is considerable, continuous, and regular." Rev. Rul. 73-522, 1973-2 C.B. 226, 227 and cases cited therein.

b. Net leases generally not trade or business. *Id.*

c. Ownership of unimproved land not a trade or business. *Id.*

d. A foreign person may be regarded as engaged in trade or business in the United States because of the activities of an agent. I.R.C. § 864(c)(5)(A).

2. A foreign person who is a partner in a partnership or a benefi-

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ciary of a trust will be regarded as engaged in trade or business in the United States if the partnership or trust is so engaged. I.R.C. § 875.

3. The net election. A foreign person not otherwise engaged in trade or business in the United States may, in order to obtain the benefit of deductions, elect to be so treated, either under the provisions of I.R.C. § 871(d) or § 882(d), or under income tax treaties.
 - a. The Code election is generally revocable. Reg. § 1.871-10(d).
 - b. The treaty election is made on an annual basis.
 4. Return must be filed or deductions can be lost. I.R.C. §§ 874(a), 882(c)(2).
- B. If a foreign person is not engaged in trade or business in the United States, *gross* rents will be taxed at 30%. I.R.C. § 871(c)(1).
1. Withholding. I.R.C. §§ 1441, 1442.
 2. Includes amounts not actually received by the foreign taxpayer. *See supra* Rev. Rul. 73-522.
 3. Treaty relief unlikely, even absent a permanent establishment, since income from real estate is generally taxable at source. *But see* article XI of the United States-Canada Income Tax Convention, which limits the tax to 15%. 1 TAX TREATIES (CCH) ¶ 1217 (1942).
- C. Remittance of Operating Profit.
1. No additional U.S. tax when a foreign person who is taxed on rental income in the United States merely transfers that income abroad.
 2. If rental income is earned by a corporation controlled by foreign investors, in addition to the U.S. tax on the operating income, there may be a withholding tax when that corporation pays dividends. *See* I.R.C. § 1442.
 - a. Domestic corporation controlled by foreigners. Dividends paid by a domestic corporation earning 20% or more of its gross income in the United States will be subject to withholding tax when distributed to foreign investors. I.R.C. § 861(a)(1)(B).
 - 1) Treaty reduction in rates.
 - 2) Leverage, *i.e.*, use of debt to create interest deductions.
 - b. Dividends received from a foreign corporation will be subject to U.S. withholding tax only if 50% or more of the foreign corporation's gross income for the three year pe-

riod ending with the year preceding the distribution is effectively connected with the conduct of a trade or business in the United States. I.R.C. § 861(a)(2)(B).

- 1) Tax is proportional to U.S. effectively connected income. *Id.*
- 2) Sometimes waived by treaty.
- c. Personal holding company (PHC) and accumulated earnings taxes.
 - 1) Foreign corporation having no U.S. shareholders during the last half of its taxable year generally not subject to PHC tax. I.R.C. § 542(c)(7).
 - 2) Accumulated earnings tax applies to U.S. source income of a foreign corporation even if all its shareholders are nonresidents, if 50% or more of its gross income is effectively connected with the conduct of a trade or business in the United States. Reg. § 1.532-1(c). *See also* Prop. Reg. § 1.532-1(c).
 - 3) Waived in some treaties.

II. DISPOSITIONS OF U.S. REAL PROPERTY

A. Background.

1. Prior to the Foreign Investment in Real Property Tax Act (FIRPTA), a foreign person was not subject to tax on gain on the sale or exchange of U.S. real property unless that gain was effectively connected with the conduct of a trade or business in the United States or, in the case of an individual, the person was physically present in the United States for 183 days or more during the year. I.R.C. §§ 871(a)(2) and (b), 882(a).
2. Under this regime, it was extremely easy for a foreign person to avoid paying any U.S. tax on the gain on a sale of U.S. real property. Popular methods included:
 - a. Installment sales.
 - b. Tax-free exchanges for foreign real estate.
 - c. Indirect ownership through holding companies whose stock could be sold free of U.S. tax.

B. FIRPTA.

1. FIRPTA, the Foreign Investment in Real Property Tax Act of 1980, Pub. L. No. 96-499, §§ 1121-1125, 94 Stat. 2599, 2682-91, *amended by* ERTA, the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 831, 95 Stat. 352 (1981), was en-

acted to foreclose these avoidance techniques and subject foreign investors in U.S. real estate to U.S. tax on the same basis as U.S. investors.

- a. New section 897 added to Internal Revenue Code.
 - b. In addition to detailed statutory rules, the Treasury is given broad authority to override nonrecognition provisions where necessary to accomplish the purposes of the Act. I.R.C. § 897(e)(2).
 - c. Effective date.
 - 1) Generally applicable to dispositions after June 18, 1980. I.R.C. § 897(k).
 - 2) Several U.S. treaties, most notably with the Netherlands, insulate treaty country residents from U.S. tax on sale of capital assets in the absence of a permanent establishment. *See* Article XI, 2 TAX TREATIES (CCH) ¶ 5815 (1948). *See also* the U.S. treaties with Belgium, Canada, Finland, West Germany, Japan, Poland, Rumania, and Sweden, 1 & 2 TAX TREATIES (CCH).
 - i) No treaty override prior to 1985. FIRPTA § 1125(c)(1).
 - ii) Period can be shortened if a renegotiated treaty is effective prior to that time, or extended for up to two years by explicit provision in a treaty signed prior to January 1, 1985. FIRPTA § 1125(c)(2), *amended by* ERTA § 831(h).
 - 3) Special rule prevents tax-free step-up in basis in transactions between related persons after December 31, 1979. *See infra* section II.B.11. of this outline.
 - d. Special transitional rules apply to liquidations of foreign corporations whose stock was acquired before enactment. I.R.C. §§ 897(k) and (1).
2. Imposition of the Tax. I.R.C. § 897(a).
- a. Gain realized by a foreign person on the "*disposition of a United States real property interest*" is taxed "as if the taxpayer were engaged in a trade or business within the United States during the taxable year and as if such gain or loss were effectively connected with such trade or business."
 - 1) Normal individual or corporate rates if ordinary income.

- 2) Capital gain. Special alternative minimum tax provision, I.R.C. § 897(a)(2), in effect increases rate on first \$60,000 to 20%.
 - 3) Presumably treated as effectively connected with U.S. trade or business for all purposes, including I.R.C. § 861 source rules.
- b. Gain is U.S. source regardless of place of sale. I.R.C. § 861(a)(5). Consequently the United States will not give a credit for foreign tax. *See* I.R.C. § 906(b)(1).
- c. Losses.
- 1) Loss on disposition deemed effectively connected under FIRPTA. For individual taxpayers, taken into account only if incurred in business, transaction entered into for profit, or if a result of casualty. I.R.C. § 897(b).
 - 2) Other effectively connected deductions can offset gain, regardless of business. I.R.C. § 897(c).
 - i) Are purchase-money interest and taxes deductible in year of sale? *See* I.R.C. §§ 897(a), 163(d), 873(a), 882 (c)(1)(A).
 - ii) Do interest and taxes in prior year produce net operating loss? *See* Reg. §§ 1.873-1(a); 1.882-4(c); 1.861-8(b), (d). *Compare* Reg. § 1.871-10(c). Can they be capitalized? *See* I.R.C. § 266 and Reg. § 1.266-1(b) which requires that items may be capitalized only if they were otherwise deductible. Taxpayer must, therefore, have been engaged in trade or business in the United States. A net election could be made if property is income producing.
 - 3) Non-effectively connected losses can be converted to effectively connected by transfer to a United States Real Property Holding Corporation (USRPHC).
 - i) Example 1. Nonresident alien A owns all of the stock of domestic company D, whose sole asset is U.S. real estate. The D stock has an adjusted basis of 40 and a fair market value of 100. A also owns some marketable U.S. securities having a basis of 200 and a fair market value of 150. If A contributes the securities to D, the new adjusted basis for the D stock is 240 and its fair market value is 250.

A's gain on the sale of the U.S. real estate is thus effectively reduced by losses which would not otherwise be effectively connected.

- ii) Example 2. Foreign corporation F is profitably engaged in trade or business in the United States. F owns some foreign real estate which has declined in value. F exchanges that foreign real estate for depreciable U.S. investment real estate. After holding it for long enough to satisfy I.R.C. § 1031, F sells the property at a loss (ordinary under I.R.C. § 1231), which it uses to offset its U.S. operating profits.

d. Installment Sales.

- 1) Installment sales treatment should remain available despite Treasury authority to override nonrecognition provisions.
- 2) Gain on collection or disposition would continue to be treated as gain on the disposition of USRPI. *See* I.R.C. § 453B(a).
- 3) Electing out of the installment method. I.R.C. § 453(d).
 - i) Cash method taxpayer includes only fair market value of note.
 - ii) If simple interest of 9% is provided, no further interest will be imputed. *See* Reg. 1.483-1(d)(1)(ii)(c). No original issue discount since notes issued for property. I.R.C. § 1232(b)(2), last sentence.
 - iii) Since sale was a "closed" transaction, excess of amount collected over basis of notes should not be subject to I.R.C. § 897(a). *Contra* Temp. Reg. § 6a.897-1(d)(3)(ii) which provides explicitly that an installment obligation from the disposition of a U.S. real property interest will be treated as an interest in real property other than an interest solely as a creditor. At least if the note is a corporate note so that collection is treated as a sale or exchange under I.R.C. § 1232(a)(1), no U.S. withholding should be required on the payments. If not treated as a sale or exchange, withholding might be required if the income is regarded as U.S.

source and there is no protection under a treaty "other income" article.

3. United States Real Property Interest (USRPI)

- a. USRPI, gain on the disposition of which is subject to tax, is broadly defined to include most forms of direct interest in real estate and equity interests in domestic corporations whose assets consist, directly or indirectly, primarily of real estate. I.R.C. § 897(c)(1).

b. Definition of USRPI.

- 1) Any interest in real property located in the United States or the Virgin Islands. I.R.C. § 897(c)(1)(A)(i).

- i) "Real property" includes movable walls, furnishings and other personal property "associated with" the use of the real property. *See* Temp. Reg. § 6a.897-1(b)(4).

- (a) The Conference Report indicates that the term is intended to have the broad meaning which it has under the U.S. Model Income Tax Treaty. H.R. REP. NO. 96-1479, 96th Cong., 2nd Sess. 186, *reprinted in* 1980 U.S. CODE CONG. & AD. NEWS 5903, 5968. Article 6(2) of the U.S. Model Treaty provides:

The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture or forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of or the right to work, mineral deposits, sources and other natural resources

1 TAX TREATIES (CCH) ¶ 158 (1977).

- (b) Potentially extremely expansive. But Temporary Regulations limit somewhat. Temp. Reg. § 6a.897-1(b)(4).
 - (1) Furnishings whose values depend principally on factors other than their functional use (*e.g.*, antiques) not included.
 - (2) Personal property is "associated with" the

use of real property if its use is "an ordinary and necessary corollary" of the use to which the real property is put, but not if the personal property "has dominant economic significance in relation to the underlying real property."

- (3) Thus mining and farming machinery are "associated," but factory machinery, office equipment, harvested crops, and livestock generally are not.
- ii) "Interest in Real Property" included fee ownership and co-ownership of land or improvements thereon, leaseholds of land or improvements thereon, options to acquire leaseholds of land or improvements thereon. I.R.C. § 897(c)(6)(A).
 - (a) Mortgages not included as long as they represent an interest solely as a creditor. Temp. Reg. § 6a.897-1(c).
 - (b) Equity participation mortgages are USRPIs. Temp. Reg. § 6a.897-1(d)(3)(i).
 - (c) "Aggregation rule" requires consideration of interests held by certain related parties in deciding whether a particular interest is an interest solely as a creditor. Temp. Reg. § 6a.897-1(d)(2).
- 2) Any interest in a domestic corporation, unless:
 - i) Interest solely as a creditor. I.R.C. § 897(c)(1)(A)(ii).
 - (a) Convertibles, participating debentures, etc., covered. Options to acquire stock are USRPIs. Temp. Reg. § 6a.897-1(d)(4), last sentence.
 - (b) I.R.C. § 385.
 - ii) The interest is a class of stock regularly traded on an established securities market and the person disposing of the stock held no more than 5% of that class at any time during the five year period. Modified I.R.C. § 318 attribution rules apply. *See infra* section II.B.3.c.3) iii) of this outline.
 - iii) Taxpayer establishes, under regulations to be provided, that, at no time during the shorter of the

period for which he or she held the stock or the five year period ending on the date of disposition of the stock, was the corporation a USRPHC. I.R.C. § 897(c)(1)(A)(ii).

- 3) An interest in a foreign corporation is not a USRPI.

Id.

- c. A corporation, foreign or domestic, is a USRPHC if the fair market value of its USRPIs equals or exceeds 50% of the sum of the fair market value of its USRPIs, foreign real estate and other assets used or held for use in its trade or business. Temp. Reg. § 6a.897-2 contains elaborate rules for establishing that a corporation is not a USRPHC, including rules for the dates on which determinations must be made and the manner in which interests in other entities are to be taken into account.

- 1) USRPI

$$\frac{\text{USRPI}}{\text{USRPI} + \text{foreign real estate} + \text{business assets}} \geq 50\%$$

I.R.C. § 897(c)(2).

- 2) The Temporary Regulations make no allowance for working capital as a business asset; cash and marketable securities are excluded from the denominator. Temp. Reg. § 6a.897-1(h). This rule is likely to be changed before the Regulations become final. An anti-avoidance rule disregards assets acquired for the purpose of enabling a corporation to come under 50% threshold. Temp. Reg. § 6a.897-2(f)(2).
- 3) For purposes of determining whether a corporation is a USRPHC, the term USRPI includes stock in a foreign corporation which is a USRPHC. Temp. Reg. § 6a.897-2(g).
- i) Example 1. Domestic corporation D's only asset is a 25% interest in foreign corporation F, whose assets consist of U.S. real estate having a fair market value of 120 and unrelated business personalty with a fair market value of 80. F is an USRPHC because its U.S. real property has a fair market value in excess of 50% of the relevant assets. Therefore, for purposes of characterizing the stock in D as a USRPI, F stock is a USRPI even though F is a foreign corporation. Thus D's only asset

(the F stock) is a USRPI, and D's stock is a USRPI. The result would be the same if, in addition, D owned foreign real estate with a fair market value of 50 since the value of the D stock, a USRPI, would be 50% of the value of the relevant assets. (It would be different, however, if F owned the foreign realty, because F would no longer be a USRPHC.) If F's personalty consisted of investment securities worth 150, F would still be a USRPHC because nonbusiness personalty does not enter into the denominator of the qualifying fraction.

- ii) Example 2. If, in Example 1, F were a partnership (*see* Temp. Reg. § 6a.897-2(h)), D would be treated as owning 25% of each of Y's assets. Thus, D's assets would consist of 60% U.S. real property, and the stock of D would be a USRPI.
 - iii) Example 3. If, in Example 1, D had owned a "controlling interest," *i.e.*, 50% or more of the fair market value of all classes of stock in F (*see* Temp. Reg. § 6a.897-2(i)), D would be treated as owning a pro rata share of each of F's assets (and would be treated as using them in its business if F did). This rule applies to multiple tiers. *Id.* In determining whether X has a "controlling interest," I.R.C. § 318 attribution rules apply, with 5% being substituted for 50% in I.R.C. § 318(a)(2)(C) and (3)(C).
- d. Exclusion for interest in domestic corporation which has disposed of all USRPIs in taxable transactions.
- 1) Requirements.
 - i) No USRPIs at time stock is sold. I.R.C. § 897(c)(1)(B)(i).
 - ii) Any USRPIs owned by it during test period were disposed of in transactions in which full amount of gain was recognized (or ceased to be USRPIs because a subsidiary recognized all its gain on USRPIs). I.R.C. § 897(c)(1)(B)(ii).
 - 2) Example. Domestic corporation D is wholly owned by nonresident alien N, who has a basis of 100 for its D stock. D was organized in 1981, at which time the fair market value of its U.S. real estate exceeded 50% of all

of its assets. In 1983 and 1984, however, D develops intangibles valued at 400, whereas the U.S. real estate, whose basis is 75, is valued at 100. In 1985 unrelated purchaser offers N 500 for its stock in D. N's stock in D is a USRPI because more than 50% of the fair market value of D's assets consisted of U.S. real property during the earlier part of the test period. On the sale of the stock, N's full gain of 400 would therefore be subject to U.S. tax. If, however, D were to sell its U.S. real estate to the buyer prior to the adoption of a plan of liquidation in an I.R.C. § 337 "straddle" and then sell the remaining assets, 25 in gain would be recognized by D, but N would not be taxed on the liquidation because the D stock would no longer be a USRPI.

4. Nonliquidating Distributions of USRPIs by Domestic Corporations. I.R.C. § 897(f).
 - a. Prior to FIRPTA, a domestic corporation could distribute U.S. real property to foreign shareholders who would receive a fair market value basis at the cost of withholding tax.
 - 1) Withholding rates were reduced by treaty.
 - 2) Unlike a domestic corporate distributee, a foreign corporate distributee gets a fair market value basis if the dividend is not effectively connected with the recipients' conduct of a U.S. trade or business. I.R.C. § 301(d)(3).
 - b. I.R.C. § 897(f) now provides that the distributee's basis will be the adjusted basis to the distributor, increased by any gain recognized by the distributor and any tax paid by the distributee.
 - 1) Applies whether or not the domestic corporation is an RPHC. *Id.*
 - 2) Example. Domestic corporation D distributes to foreign parent F U.S. real property having an adjusted basis of 60 and a fair market value of 100. D recaptures 10 of accelerated depreciation and withholds 5 tax on the dividend under the United States-Country F Treaty. F's adjusted basis for the U.S. real estate received will be 75: D's adjusted basis of 60, increased by the 10 gain recognized by D and by the 5 tax withheld by D on distribution.

- 3) Query Secretary's authority to require D to recognize the full 40 gain under I.R.C. § 897(e)(2). *See infra* section II.B.8. of this outline.
5. Real Estate Investment Trusts (REIT). I.R.C. § 897(h).
 - a. Sale of REIT stock.
 - 1) Not a USRPI if *domestically controlled*. I.R.C. § 897(h)(2).
 - i) Less than 50% in value of the stock held directly or indirectly by foreign persons at all times during the testing period. I.R.C. § 897(h)(4)(B).
 - ii) Testing period is the five year period ending on the date of disposition or the shorter period during which the REIT is in existence. I.R.C. § 897(h)(4)(D)(ii) and (iii). The seller need not have held the stock at that time.
 - 2) If not domestically controlled, share sales subject to tax under normal rule for stock in U.S. corporations.
 - b. Distributions by a REIT.
 - 1) "Look-through" rule for any distribution to a foreign person. I.R.C. § 897(h)(1).
 - i) To the extent attributable to gain from the sale or exchange of a USRPI, treated as gain recognized by the distributee on the sale of a USRPI. *Id.*
 - ii) Presumably shareholder entitled to protection of treaty protecting stock sales, since not explicitly treated as a sale of the real estate itself. Compare partnerships.
 - 2) Tier Possibility? Suppose REIT X, which is entirely owned by foreign persons, owns a substantial part of the stock of REIT Y, which owns U.S. real estate. Y sells a parcel of U.S. real estate and distributes the proceeds to X, which in turn distributes them to its shareholders. Since the distribution from Y to X is not to a foreign person, X is not treated as having sold a USRPI under I.R.C. § 897(h)(1). Therefore X's distribution to its shareholders does not appear to be attributable to a sale *by it* of a U.S. real property interest so as to make I.R.C. § 897(h)(1) applicable to X's shareholders. Moreover, if the distribution to X is a capital gain dividend, its distribution to its shareholders is

also a capital gain dividend free of withholding. *See* Rev. Rul. 69-244, 1969-1 C.B. 215.

- 3) Distribution of a USRPI. I.R.C. § 897(h)(3). If a domestically controlled REIT distributes a USRPI, it will be required to recognize gain under rules similar to those promulgated in I.R.C. § 897(d). *See infra* section II.B.6.b. of this outline.
 - i) Since sale of its shares is not taxed, it is treated in this respect like a foreign corporation.
 - ii) However, the percentage of the gain recognized by the REIT is limited to its *foreign ownership percentage*, which is defined as the largest direct or indirect foreign ownership during the test period. I.R.C. § 897(h)(4)(C). Note that under this rule the REIT will be required to recognize this gain even if at the time of the distribution it has no foreign shareholders.
 - iii) Not clear whether this gain is taxed to the REIT, or to its shareholders. *See* I.R.C. § 857(b).
 - iv) If the REIT is not domestically controlled, the REIT is treated like any other domestic corporation subject to the rules of I.R.C. § 897(f). *See supra* section II.B.5. of this outline.
6. Foreign Corporations.
 - a. Since stock in a foreign corporation is not a USRPI, the sale of that stock is not taxable under I.R.C. § 897 even if the corporation owns nothing but U.S. real estate.
 - b. Disposition of U.S. real estate by foreign corporation I.R.C. § 897(d)(1).
 - 1) Sale subject to tax. *Id.*
 - i) I.R.C. § 337 inapplicable. I.R.C. § 897(d)(2).
 - ii) Like-kind exchange probably nontaxable only if interest received is a USRPI. *See infra* discussion of I.R.C. § 897(e) at section II.B.8. of this outline.
 - 2) Distribution of USRPI by a foreign corporation.
 - i) Notwithstanding nonrecognition provisions, gain recognized in amount of excess of fair market value at the time of distribution over adjusted basis. I.R.C. § 897(d)(1)(A).
 - ii) Exceptions.
 - (a) Distributee subject to U.S. tax on subsequent

disposition and distributee's basis no greater than distributor's (increased by any gain recognized to distributor). I.R.C. § 897(d)(1)(B)(i)(I).

- (b) As the Secretary provides in regulations. I.R.C. § 897(d)(1)(B)(ii) and (e)(2).
- (c) Is recognition required under these rules on a distribution to a *domestic* corporation? Suppose nonresident alien A owns all the stock of NV, a Netherlands Antilles corporation, whose only asset is U.S. real estate. A forms BV, a dutch corporation which in turn forms D, a domestic subsidiary. A contributes his NV stock to BV which in turn contributes it to D. Subsequently, BV sells all of the stock of D to an unrelated person, who first liquidates NV (into D) and then liquidates D within I.R.C. § 334(b)(2) period. Since D was not subject to tax on this disposition (even though it would have been on sale), the distribution from NV to D could fail the test of I.R.C. § 897(d)(1)(B)(i) and cause NV to recognize gain. Alternatively, the Treasury might exercise its authority under I.R.C. § 897(e) (*see infra* section II.B.8. of this outline) to deny D the benefit of I.R.C. § 332. Note that under new I.R.C. § 338, D would not be a "target affiliate" and there would appear to be no step-up in the basis of D's assets. If, however, NV were liquidated into D prior to the sale of D stock, the purchaser could get a step-up by making an I.R.C. § 338 election.

3) Examples.

- i) Example 1. All of the stock of NV, a Netherlands Antilles corporation owning U.S. real estate, is sold to BV, a Dutch corporation, which liquidates NV under I.R.C. § 334 (b)(2) in order to obtain a step-up in basis for the U.S. real estate. Absent an election, NV must recognize gain on the liquidation in the amount of the difference between its adjusted basis for the real estate and the fair mar-

ket value. The statutory exception in I.R.C. § 897(d)(1)(B) does not apply because BV gets a stepped-up basis.

- ii) Example 2. BV, a Dutch corporation, owns all of the stock of NV, a Netherlands Antilles corporation, which owns all of the stock of D, a domestic corporation owning U.S. real estate. NV is liquidated, distributing all of its stock in D to its parent BV. Although BV would take a carryover basis for the stock in D, NV would be required to recognize gain in the amount of the difference between its adjusted basis for the D stock and the fair market value of that stock because, at the time of the distribution, the stock would not be subject to taxation on a sale by BV because of the United States-Netherlands Income Tax Treaty. 2 TAX TREATIES (CCH) ¶ 66001 (1948).

4) Discrimination Problem.

- i) Many U.S. treaties prohibit more burdensome U.S. tax treatment of a foreign permanent establishment than would be imposed on a U.S. corporation similarly situated. Typical is the provision found in paragraph (3) of article 24 of the U.S. Model Treaty. "The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities." 1 TAX TREATIES (CCH) ¶ 1022 (1981).

- ii) Denial to foreign corporations of nonrecognition provisions available to domestic corporations could violate this nondiscrimination provision.

- iii) Statutory solution is to grant foreign corporations an election to be treated as domestic corporations. See *infra* section II.B.7. of this outline.

7. Election to be treated as a domestic corporation. I.R.C. § 897(i) and Temp. Reg. § 6a.897-3.

- a. A foreign corporation, claiming discrimination because of unavailability of nonrecognition provisions available to a

domestic corporation, is given an election to be treated as a domestic corporation. I.R.C. § 897(i)(1).

- 1) Obtain benefits of nonrecognition provisions.
- 2) Revocable only with consent. I.R.C. § 897(i)(2).
- 3) Exclusive remedy for anyone claiming discrimination. I.R.C. § 897(i)(4).

b. Requirements.

- 1) Corporation holds USRPI. I.R.C. § 897(i)(1)(A).
- 2) Entitled to nondiscrimination under treaty. I.R.C. § 897(i)(1)(B).

i) Antilles question - under what circumstances is a Netherlands Antilles corporation a resident of the United States within the meaning of the nondiscrimination article of the treaty?

ii) Treaty of Friendship, Commerce and Navigation will normally contain provisions similar to those in paragraphs 1 and 2 of article XI of the United States-Netherlands Treaty (which also applies to the Antilles), as follows:

Nationals of either Party residing within the territories of the other Party, and nationals and companies of either party engaged in trade or other gainful pursuit or in scientific, educational, religious or philanthropic activities within the territories of the other Party, shall not be subject to the payment of taxes, fees or charges imposed upon or applied to income, capital, transactions, activities or any other object, or to requirements with respect to the levy and collection thereof, within the territories of such other Party, more burdensome than those borne by nationals and companies of such other Party.

With respect to nationals of either Party who are neither resident nor engaged in trade or other gainful pursuit within the territories of the other Party, and with respect to companies of either Party which are not engaged in trade or other gainful pursuit within the territories of the other Party, it shall be the aim of such other Party to apply in general the principal set forth in paragraph 1 of the present article.

Treaty of Friendship, Commerce & Navigation, Mar. 27, 1956, United States - Netherlands, art. XI, ¶ 1, 2, 8 U.S.T. 2043, 2060, T.I.A.S. No. 3942, 285 U.N.T.S. at 231, 247.

- 3) Consent of holders of all noncreditor interests.
 - i) Exception for regularly traded stock of 5% at all times during five year period. I.R.C. § 897(c)(3).
 - ii) Must "agree that gain, if any, from the disposition of such interest after June 18, 1980, which would be taken into account under subsection (a), shall be taxable notwithstanding any provision to the contrary in a treaty to which the United States is a party." I.R.C. § 897(i)(3).
 - (a) For example, Dutch shareholder of BV owning USRPI, in order to obtain benefit of I.R.C. § 337 for BV, must agree to waive the insulation from tax on share sales otherwise provided by the Dutch treaty, even though sale of stock in a U.S. corporation would not be subject to tax.
 - (b) Discriminatory?
- 4) Election "subject to such other conditions as the Secretary may prescribe by regulations with respect to the corporation or its shareholders." *See* Temp. Reg. § 6a.897-3(b).
 - i) No election if any interest in the corporation was "disposed of" at any time after corporation held a USRPI. Temp. Reg. § 6a.897-3(b)(1). Transitional rule for dispositions prior to March 21, 1983. Temp. Reg. § 6a.897-3(b)(2).
 - ii) Neither shareholder nor corporation may avail itself of any treaty protection with respect to gain otherwise recognizable under I.R.C. § 897(a) on such interest. In IR 83-16 (*see* DAILY TAX REP. (BNA) No. 16 at G-4 (Jan. 24, 1983)), the IRS announced that it would amend this section of the regulations to require that the electing corporation pay tax on any gain recognized on the disposition of the USRPI.
 - iii) Formal requirements. Temp. Reg. § 6a.897-3(e).
 - (a) Indicate applicable treaty.

- (b) Describe USRPIs, including acquisition dates, adjusted basis, and fair market value.
 - (c) State that there have been no prior dispositions.
 - (d) Agreement to be bound by conditions.
 - (e) Anti-abuse rule not applicable. *See infra* section II.B.7.b.4)v) of this outline.
 - (f) Names and addresses of all holders of interest, and description of interest.
 - (g) Consent.
 - (h) Certain prior dispositions to related persons.
 - iv) Election must be made by later of March 21, 1983 or 90 days after the acquisition of a USRPI. Temp. Reg. § 6a.897-3(f)(1).
 - v) Anti-abuse rule designed to avoid use of multiple tiers to avoid the rule that no election is permissible once there has been a disposition of an interest in the corporation which held the USRPI.
- c. Effect of election.
- 1) Treated as a domestic corporation only for purposes of I.R.C. §§ 897 and 6039C. I.R.C. § 897(i)(1).
 - i) No consolidated return. I.R.C. § 1504(b)(3).
 - ii) Source of distributions determined as for foreign corporations. I.R.C. § 897(d).
 - iii) No treaty benefits. Temp. Reg. § 6a.897-3(d).
 - iv) Estate tax inapplicable to stock.
 - (a) Should be able to make tax-free I.R.C. § 351 transfer.
 - (b) *Cf.* I.R.C. § 897(j). *See infra* section II.B.9. of this outline.
 - 2) Nonrecognition sections applicable, for example, I.R.C. §§ 336, 337. I.R.C. § 897(e).
 - i) For example, a typical I.R.C. § 334(b)(2) liquidation or § 338 election.
 - ii) Does FIRPTA section 1125(d) deny step-up on I.R.C. § 334(b)(2) liquidation? *See infra* section II.B.11. of this outline
 - iii) Inability to benefit from I.R.C. § 337 if upper tier holding company is not in a treaty country.
 - 3) Tax at shareholder level.

- i) Amount of gain may be different than corporate gain on USRPI.
 - (a) Stock basis different from corporation's basis for USRPI; step-up at death.
 - (b) Entire gain, not just that on USRPI taxable.
 - ii) Installment sales available. *See* I.R.C. § 453(h).
 - iii) Capital gains rate 20%, as compared to 28%. I.R.C. § 897(a)(2).
 - iv) State tax implications:
 - (a) State may have corporate franchise tax, but no individual income tax.
 - (b) If state has no equivalent of either I.R.C. §§ 337 or 897, probably prefer share sale. For example, California, which has amended § 24514 to make its equivalent of I.R.C. § 337 inapplicable to corporations having non-U.S. shareholders. CAL. REV. & TAX, § 24514 (West Supp. 1983).
- 4) Foreign tax credit problem.
- i) Treated as domestic source. I.R.C. § 861(a)(5).
 - ii) No U.S. foreign tax credit for foreign tax. I.R.C. § 906.
8. Nonrecognition Provisions. I.R.C. § 897(e).
- a. Nonrecognition provisions applicable for purpose of I.R.C. § 897 only in the case of an exchange of a USRPI for an interest the sale of which would be subject to tax. I.R.C. § 897(e)(1).
 - 1) Otherwise inapplicable to both domestic and foreign corporations, but only where transfer would otherwise be subject to I.R.C. § 897.
 - 2) Examples.
 - i) I.R.C. § 1031 would apply to the exchange by a foreign corporation of U.S. real property for other U.S. real property, but not to an exchange of U.S. real property for foreign real property.
 - ii) I.R.C. § 1031 presumably would apply to an exchange by a U.S. corporation of U.S. real property for foreign real property since I.R.C. § 897 would not apply to that exchange. Moreover, the sale of that foreign real property by a U.S. corporation would be subject to tax. But what if foreign share-

holders were planning to wait out the five year taint period and liquidate the corporation under I.R.C. § 337? *Cf.* Temp. Reg. § 6a.897-2(f)(2). Or have the corporation distribute the foreign real estate as a dividend? Neither I.R.C. § 897(e)(1) nor the authority given the Secretary under I.R.C. § 897(e)(2) to issue regulations overriding nonrecognition appears sufficiently broad to deny I.R.C. §§ 337 or 311 at the later time.

- iii) A merger of a domestic USRPHC into a domestic company which was not a USRPHC after the merger would not enjoy the protection of the reorganization provisions. Presumably only foreign shareholders will be required to recognize gain.
- b. Broad authority in the Secretary to provide by regulation the circumstances under which the nonrecognition provisions should or should not apply. I.R.C. § 897(e)(2). *But not unlimited.*
 - 1) Can override any nonrecognition provision otherwise applicable to a transfer by a foreign person. I.R.C. § 897(e)(2)(A).
 - 2) Can override nonrecognition provisions applicable to domestic transferors only in the case of reorganizations and distributions from a partnership, estate, or trust. I.R.C. § 897(e)(2)(B).
- 9. Foreign person contributing a USRPI to the capital of a foreign corporation. I.R.C. § 897(j).
 - a. On the transfer by a foreign person of a USRPI as a contribution to the capital of a foreign corporation, the transferor recognizes gain in amount equal to the excess of the fair market value of the property over the sum of its adjusted basis and the amount of gain otherwise recognized by the transferor. *Id.*
 - 1) Purpose is to prevent restructuring of existing holdings to take advantage of treaties.
 - 2) For example, a Netherlands Antilles corporation owning stock in a domestic RPHC would not be able to make a tax-free transfer of that stock to a Dutch corporation in order to take advantage of the provision of the Dutch treaty protecting a Dutch resident from U.S. tax on the sale of shares.

- b. Presumably an electing corporation is not a foreign corporation for this purpose.
 - c. Secretary has authority in regulations to provide for non-recognition. I.R.C. § 897(e)(2).
 - 1) Should nonrecognition be permitted where a treaty umbrella is not obtained?
 - 2) Can a foreign corporation, engaged through a branch in the manufacturing business in the United States, incorporate that branch as a foreign subsidiary under I.R.C. § 351?
10. Partnerships, trusts, and estates.
- a. Amount received by foreign person in exchange for all or part of an interest in a partnership, trust, or estate shall, to the extent attributable to USRPIs, be treated as received on sale or exchange of that property. I.R.C. § 897(g).
 - 1) Regulations will provide method of attribution. *Id.*
 - i) Presumably allocation will normally be in accordance with fair market value. Provision will have to be made for special allocations under I.R.C. §§ 704(b) and (c).
 - ii) Since it is "amount received" which is allocated, tax only if gain on USRPI.
 - iii) Could have tax even if loss on sale of interest.
 - 2) Applicable even if U.S. real property interest represents a very small part of partnership assets.
 - 3) Presumably nonrecognition provisions apply to the same extent they would on transfer of underlying USRPI.
 - b. Distributions.
 - 1) Partnerships.
 - i) Applicable to partnership cash distributions in excess of basis.
 - ii) Property distribution should not precipitate recognition of gain because of carryover basis.
 - iii) Authority under I.R.C. § 897(e) to provide the extent to which changes in interests in, or distribution from, a partnership, trust, or estate, shall be treated as sales of property at fair market value.
 - (a) Perhaps non-pro rata distributions will be subjected to I.R.C. § 751-type rules in some cases.

- (b) Example. Partnership AB has two parcels of real property, X, located in the U.S., and Y, located abroad. Each has an adjusted basis of 100 and a fair market value of 150. If X is distributed to U.S. citizen A and Y is distributed to nonresident alien B, is any gain recognized? Suppose both parcels were, immediately thereafter, sold to C? Compare the results if A and B had sold their partnership interests to C; if AB had been a corporation, foreign or domestic.
 - (c) Could also apply to amendment of partnership agreement.
- 2) Trusts and estates.
 - i) Foreign situs trust or estate taxable at trust level. I.R.C. § 643(a)(6)(A). Should obtain a distribution deduction, however.
 - ii) Beneficiaries.
 - (a) Current distributions retain character in beneficiaries' hands. I.R.C. § 652(b). These distributions should be taxable to extent attributable to trust gain on sale or exchange of USRPI.
 - (b) Accumulation Distributions.
 - (1) If from foreign situs trust to foreign person, retains character. I.R.C. §§ 667(a) and (e), 643(a)(6)(C).
 - (2) If from foreign trust to U.S. person, character lost; lose benefit of capital gain.
 - (3) If from domestic trust, not taxable to beneficiary if attributable to capital gain, since not includable in distributable net income. I.R.C. § 643(a)(3).
- 11. Adjustment in basis for certain sales to related person. FIRPTA § 1125(d).
 - a. Attempt to curtail step-up in basis on sales between related parties which were not subject to U.S. tax either because they occurred shortly before the June 19, 1980, effective date of FIRPTA or because they were exempt by treaty from U.S. tax.
 - b. Requires reduction in basis by amount of "non-taxed

gain" in case of disposition after December 31, 1979 to a related person.

- 1) A "related person" is one whose stock would be attributed to the person disposing of the property under the I.R.C. § 318 attribution rules (excluding the option attribution rule). *See* I.R.C. § 453(f)(1).

Example. D, a domestic corporation owning U.S. realty, is a wholly owned subsidiary of BV-1 a Dutch corporation, in which unrelated nonresident aliens A and B are equal 50% shareholders. BV-1 sells all of the D stock to D-2, a wholly owned domestic subsidiary of BV-2, a Dutch corporation, and D is liquidated into D-2 under the provisions of I.R.C. § 334(b)(2). BV-1 is exempt from U.S. tax on the sale under article XI of the United States-Netherlands treaty. 2 TAX TREATIES (CCH) ¶ 5815 (1948).

- i) If A and B were also equal 50% shareholders in BV-2, BV-2 would be a related party and its basis in D stock (and consequently in D's assets) would have to be reduced.
 - ii) If A, B, and unrelated individual C were equal shareholders of BV-2, basis reduction would apply if the term "whose stock" in I.R.C. § 453(f)(1) refers to BV-1's own stock, but not if it refers to stock owned by BV-2's since I.R.C. § 318 does not apply to attribute ownership to a less than 50% shareholder. The latter appears to be the correct interpretation. Senate Report 100, accompanying the Installment Sales Revision Act of 1980, states: "In the case of a corporation, it will be considered to be related to another taxpayer, if stock which is or might be owned by it is or would be treated as owned by the other taxpayer under the general corporate attribution rules." S. REP. NO. 100, 96th Cong., 2nd Sess. 16, *reprinted in* 1980 U.S. CODE CONG. & AD. NEWS 4696, 4711.
 - iii) If BV-1 had been owned equally by A, B, and C (unrelated), BV-2 would not be a related party regardless of its stock ownership.
- 2) "Disposition" probably includes a distribution in liquidation.

- 3) "Non-taxed gain" means gain which escapes U.S. tax either because the disposition occurred before June 19, 1980, or because of any treaty obligation of the U.S.
 - i) Appears to refer to transferor's gain, but literally could apply to transferee's gain on a liquidation.
 - ii) Is basis reduced in an I.R.C. § 334(b)(2) liquidation of a foreign corporation filing an I.R.C. § 897(i) election, because the election would have been unavailable and the liquidating corporation therefore subject to tax but for the nondiscrimination provisions of a U.S. treaty?

III. REPORTING REQUIREMENTS.

- A. The Senate version of FIRPTA contained a provision requiring a buyer to withhold tax on the purchase of a USRPI. This provision was deleted in Conference in favor of comprehensive reporting requirements intended to insure that the United States would obtain the information necessary to enable it to collect any tax due. These reporting requirements, contained in I.R.C. § 6039C, which will be augmented by regulations, are in addition to the requirement that foreign holders of U.S. real estate report certain holdings to the Commerce and Agriculture Departments.
- B. The temporary regulations require reporting by May 15 for the prior calendar year. Reports for 1980 and 1981 are due by June 21, 1983. The deductible for returns for 1982 has been extended to June 21, 1983 as well. *See* IR 83-6 (DAILY TAX REP. (BNA) No. 6 at G-6 (Jan. 10, 1983)).
- C. I.R.C. § 6039C imposes reporting requirements on a calendar year basis, on certain domestic corporations having non-U.S. shareholders, on substantial investors in U.S. real property through foreign corporations (or through any partnership, trust or estate), and on foreign persons holding substantial interests in U.S. real property directly.
 1. Domestic corporations having foreign shareholders. I.R.C. § 6039C(a), Temp. Reg. § 6a.6039C-2, Form 6659.
 - a. Applies to any domestic corporation, unless its stock is regularly traded on an established securities market at all times during the year, if:
 - 1) it has any foreign shareholders at any time during the calendar year, and

- 2) it is a USRPHC at any time during the calendar year or the four preceding calendar years. The IRS may require a corporation to show that it was not required to report because it was not a USRPHC. Temp. Reg. § 6a.6039C-2(a).
 - b. Must report for calendar year by following May 15.
 - 1) Name and address *if known* of any shareholder known to be a foreign person. I.R.C. § 6039C(a)(1)(A)(i).
 - 2) Information required by regulations regarding stock transfers to or from foreign persons. I.R.C. § 6039C(a)(1)(A)(ii).
 - 3) Other information required. *See* Temp. Reg. § 6a.6039C-2(b).
 - c. USRPHC is required to notify record holder who may be a nominee by January 31 (February 21, 1983 for 1980, 1981, and 1982). Temp. Reg. § 6a.6039C-2(d).
 - d. Nominees for a foreign person must file a return furnishing the information if the foreign person does not furnish the information required in *supra* section III.C.1.b. of this outline. I.R.C. § 6039c(a)(3). Note that while the reporting requirement is on the domestic corporation, it must report only names which it knows. This provision requires a nominee to file a return if the foreign person does not provide the information to the corporation.
2. Substantial investors in U.S. real property through foreign corporations (or through any partnership, estate, or trust). I.R.C. § 6039C(b), Temp. Reg. § 6a.6039C-3, Form 6660.
 - a. Applies to foreign corporation (or any partnership, estate, or trust) having a "substantial investor" in U.S. real property. I.R.C. § 6039C(b)(1).
 - 1) A "substantial investor" is any person whose *pro rata share* of the USRPIs held by the entity exceeds \$50,000 at any time during the year (in the case of a partnership, trust, or estate the person must be a foreign person). I.R.C. § 6039C(b)(4)(B)(i).
 - i) Pro rata share determined under Temp. Reg. § 6a.897-1(f).
 - ii) Example 1. Foreign corporation F, which is owned 10% by nonresident alien N and 90% by U.S. resident R, owns a parcel of U.S. real estate

- having a fair market value of \$100,000. R is a "substantial investor" and the section applies.
- iii) Example 2. If F were a partnership, there would be no "substantial investors."
- 2) For purposes of determining whether a person is a "substantial investor" when U.S. real estate is held indirectly, an entity's assets include its pro rata share of the U.S. real property owned by a corporation if the fair market value of that share exceeds \$50,000.
- 3) Attribution rules apply.
- i) USRPIs held by a partnership, estate, or trust treated as held proportionately by partners or beneficiaries. I.R.C. § 6039C (e)(1)(A).
- ii) Individual treated as owning USRPIs held by spouse or minor child. I.R.C. § 6039C(e)(1)(B).
- 4) Example. Foreign corporation F, is entirely owned by non-resident alien N. F owns all of the stock of domestic corporation D, which has a U.S. operating business. D's building, which is worth \$500,000, constitutes 20% of the fair market value of its assets. Even though D is not a USRPHC, under the "look-through" rule, F has a substantial investor and is therefore subject to reporting.
- b. Must report for calendar year by May 15.
- 1) Name and address of each substantial investor. I.R.C. § 6039C(b)(1)(A).
- 2) Information regarding assets as the regulations require. I.R.C. § 6039C(b)(1)(B).
- 3) Other information which the regulations require. I.R.C. § 6039C(b)(1)(C).
- c. Must also furnish each substantial investor with a statement by January 31 each year (extended until February 21 for years 1980, 1981, and 1982. Temp. Reg. § 6a.6039-3(h). This statement must show:
- 1) Entity's name and address. I.R.C. § 6039C(b)(3)(A).
- 2) Investor's pro rata share of U.S. real property. I.R.C. § 6039C(b)(3)(B).
- 3) Other information required by regulations. *See* Temp. Reg. § 6a.6039C-3(e).
- d. Exception for entities furnishing "such security as the Secretary determines to be necessary to ensure that any tax

imposed by chapter 1 with respect to U.S. real property interests held by such entity will be paid." I.R.C. § 6039C(b)(2). *See infra* section III.D. of this outline.

3. Foreign persons holding USRPIs directly. I.R.C. § 6039C(c), Temp. Reg. § 6039C-4, Form 6661.
 - a. Applies to any foreign person if:
 - 1) Person did not engage in trade or business in the United States during the calendar year. I.R.C. § 6039(c)(2)(A).
 - 2) Fair market value of USRPIs equals or exceeds \$50,000. I.R.C. § 6039C(c)(2)(B).
 - 3) Such person not required to file a return, (I.R.C. § 6039C(c)(2)(C)) unless *supra* section III.C.3.d. of this outline is inapplicable; *e.g.*, the partnership in example 2 *supra* section III.C.2.a.1) iii) of this outline.
 - b. Must report for calendar year by May 15.
 - 1) Name and address (I.R.C. § 6039C(c)(1)(A)).
 - 2) Description of all USRPIs held (I.R.C. § 6039C(c)(1)(B)).
 - 3) Other information required by Regulations. *See* Temp. Reg. § 6a.6039C-4(d).

D. Security. Temp. Reg. § 6a.6039C-5.

1. Available as a substitute for information reporting to any person otherwise required to report. I.R.C. § 6039C(b)(2).
 - a. If provided by one member of chain, those above in chain who would otherwise be required to report are relieved of obligation with respect to same interest. Temp. Reg. § 6a.6039C-5(f).
 - b. Similarly, statements need not be provided to substantial investors. Temp. Reg. § 6a.6039-5(e).
 - c. Directors must be satisfied that any tax on disposition during the year by entity or by holder of an interest in the entity has been or will be paid. I.R.C. § 6039C(b)(2).
 - d. Application must be made by January 31 for prior year. Extended to March 21, 1983 for 1980, 1981, and 1982.
 - e. Generally good for one year, but may be renewed annually if adjusted to reflect changes in value. Temp. Reg. § 6a.6039-5(g).
2. Type of security.
 - a. Absolute discretion in Director of the Foreign Operations District. Temp. Reg. § 6a.6039-5(b).

- b. Among possibilities are security interests, escrows, letters of credit, surety bonds, and binding voluntary withholding agreements.
- c. Guarantees by entities with sufficient assets in the United States. Temp. Reg. §6a.6039-5(e).
- 3. Amount of security.
 - a. Generally, must be sufficient to cover capital gains tax on excess of fair market value over adjusted basis. Temp. Reg. § 6a.6039-5(c).
 - b. Cannot be required to exceed ordinary income rate on same gain. *Id.*
 - c. Annual appraisal required by February 21. Extended until March 21 for 1980, 1981, and 1982. Temp. Reg. § 6a.6039-5(e).
 - d. Query what security, if any, is required if interest has already been disposed of and no tax is due because of treaty.
- E. Penalty for failure to file return or furnish statement to substantial investor, unless due to reasonable cause and not to willful neglect. I.R.C. § 6652(g), Temp. Reg. § 6a.6652(g)-1.
 - 1. \$25 per day per failure. I.R.C. § 6652(g)(2).
 - 2. Limited to \$25,000 for any calendar year for failure to comply with I.R.C. §§ 6039C(a) or (b). *Supra* sections III.C.1. and 2. of this outline. I.R.C. § 6039C(g)(2)(A).
 - 3. For failure to comply with I.R.C. § 6039C(c), limited to lower of \$25,000 or 5% of the aggregate fair market value of USRPIs owned for each calendar year. I.R.C. § 6039(g)(2)(B).